THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

June 2015

SECTION 1

Answer 01

Relevant Learning Outcome/s: 3.1.1/ 3.3.1/ 4.1.1/ 4.2.1

Suggested Detail Answer:

(a) (i) Since the deadlines for group reporting and the statutory reporting are the same, it is efficient and effective to conduct the audits in parallel. The materiality levels communicated by group auditors seem quite high compared to the financial results of the company for the year ended 31 March 2015. Since this is a PLC, if materiality is determined based on the profit before tax at either 7% or 5% it (overall materiality) will be Rs 45.5 million and Rs 32.5 million respectively in whichever case the group materiality is still high.

Therefore, the auditors of QEP have to decide which materiality is to be used for the work. Since a separate report has to be issued on the statutory financial statements, it is required to use the lower level materiality. Otherwise to form an opinion, the work will not be sufficient if the audit is based on group reporting materiality. The materiality can be set at a lower level than the group materiality and any misstatements noted that are above the group materiality can be communicated to the group auditors.

(ii) Audit procedures

Risk identified by parent auditor	Response
Management override of controls -	Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. 1. Test estimates assumptions and adjustments to the accounts The preparation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates. This may be achieved by, for example, understating or overstating all provisions or reserves in the same fashion designed either to smooth earnings over two or more accounting periods, or to achieve a

Risk identified by parent auditor	Response
	designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
	2. Evaluate business rationale for significant unusual transactions. Indicators such as involved transactions that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets. (e.g. complex transactions) Inquire from management and check the board minutes with regard to complex transactions. 3. Check suspense, inter- company and related party accounts. 4. Check the appropriateness of accounting policies and closing adjustments. 5 Test that the accounting policies have been consistently applied. - Ensure assumptions are done: - With proper authority - Are reasonable and - Not biased 6 Ensure that there is sound internal control system. 7. Ensure that there is sound corporate governance by checking the organization structure.
Valuation of finished goods	1. Understand and evaluate the management inventory valuation process and check whether it is in compliance with LAKS 2 – Inventories. Therefore, it is necessary to check whether the inventories are values at lower of cost or net realizable value. 2. Test whether the stocks are moving, and obsolete items and whether those have been taken into consideration in valuing inventories.

Risk identified by parent auditor	Response
Related party transactions	- Understand the entity's related party relationships and transactions (make inquiries of management on their procedure for identifying such transactions, and the approval process in place); check the internal control system. - Maintain alertness for related party information when reviewing records or documents, (using professional Skipton) - Ensure proper disclosure has been made. - Share related party information with the engagement team. 3. Understand the policy for valuation whether FIFO or weighted average. 4. Test whether all the components such as labour and overheads have been taken into the valuation process. 5. Obtain a sample of cost/stock cards and check the calculation of cost.

(b) (i) Sufficiency of work performed

Matter	Comments
Sales cut off	- The engagement team has only selected a sample from 30th and 31st March and lead period not identified. - The rationale for selecting these two days for cut off. Why not one or two weeks before and after. The misstatement noted although not material suggests availability of misstatement in untested population. Therefore, the sampling needs to be extended to confirm that there are no other misstatements on sales cut-off.
Xtra Super	- The dependency on Xtra is a much large issue. If the sales have not taken place as usual in February and March, what action has management taken to identify new customers as drop in sales might indicate long term in stability of the company (issue on going concern). The audit team has not followed up on this.

	- What is the management's rationale for not making an impairment charge regarding this debtor, not clear (whether there is a settlement agreement and subsequent payments have been made) - The amount is material to the financial statements and suggests the need to check for impairment,
Investment in property company	1 Not indicated whether the auditors have obtained the unaudited financial statements (at least) to assess the impact (on equity method), share of profit. 2 Are there indicators that carrying amount is impaired? **3** Check whether related party transactions are properly disclosed.

(ii) Implications of the above matters for the audit

Matter	**Implications**
Sales cut off	As suggested above the sample needs to be extended in testing cut-off of sales. If there are no other misstatements, then it is acceptable that the misstatement is not material to the financial statements. If misstatements are identified: 4 Then assess the materiality of it to the financial statements. If it is well below PM, then can take it to summary of unadjusted misstatements schedule and with other misstatements can view the overall impact to the financial statements. 5 If the misstatement warrants an adjustment to the financial statements, agree with the client for it and if client is not agreeable then consider the overall impact to the audit report (may be we need to qualify the audit report)
Xtra Super	6 If there is no settlement plan agreed and no subsequent realization of debtors, it suggests making an impairment charge on this debtor. 7 Assess the impact on going concern after discussing with the client. 8 If the impairment is required and no adjustments are made due to its materiality it may suggest a modification to the audit report.

Matter	Implications
	9 Going concern issue – include an emphasis of matter paragraph.
Investment in property company	10 Equity method to apply in accounting for investments in associate. 11 When equity method is applied, and effect is material, then this requires qualification as there are no audited financial statements. If not material to the financial statement of FTPL, qualification can be avoided. 12 More disclosures under related party transactions 13 If there is any scope limitation, getting statement of accounts or carrying out other audit procedures this may require a qualification on scope limitation.

Answer 02

Relevant Learning Outcome/s: 2.1.1/ 2.6.1/ 2.6.2

Suggested Detail Answer:

(a) ERM is about establishing the oversight, control and discipline to drive continuous improvement of an entity's risk management capabilities in a changing operating environment. It advances the maturity of the enterprise's capabilities around managing its priority risks.

- A process, ongoing and flowing through an entity
- Effected by people at every level of an organization
- Applied in strategy-setting
- Applied across the enterprise, at every level and unit, and includes taking an entity-level portfolio view of risk
- Designed to identify potential events affecting the entity and manage risk within its risk appetite
- Able to provide reasonable assurance to an entity's management and board
  Geared to the achievement of objectives in one or more separate but overlapping categories –

ERM assists management with (a) evaluating the likelihood and impact of major events and (b) developing responses to either prevent those events from occurring or manage their impact on the entity if they do occur. Most companies focus on traditional risks that have been known for some time. Few companies have a systematic process for anticipating new and emerging risks. Therefore, many companies often learn of critical risks too late or by accident. In the given scenario, management could have assessed the probability of risk of food poisoning for the entity, and after identifying the criticality of such an event, management would have taken necessary steps with awareness to avoid such event from happening. ERM assists management with improving the consistency of operating performance, as there is a conscious approach taken to avoid the most critical risks (minimize surprises and losses); risk management is considered as everybody's responsibility, the experience and practice is shared within the business.

(b) All organizations face business risk, regardless of size. Organizations ignore risk at their own peril. No organization can afford to stand pat with its existing risk management capabilities; therefore, every organization should evaluate how it can improve its risk management. The COSO framework is useful for this purpose because its gives each organization a framework with criteria against which to compare its existing risk management capabilities.
While some small and mid-size entities may implement components differently than large ones, they still can have effective enterprise risk management. The methodology is likely to be less formal and less structured in smaller entities than in larger ones, but the basic concepts should be present in every entity.

ERM does not guarantee the success of a business. It provides better information to managers and a more robust process for them to follow, but does not necessarily transform poor management skills to better management. The cost can be more than the benefit expected.

(c) (i) Integrated Framework provides insights into approaches to improve risk assessment methodologies. Therefore, internal auditors may use the framework to augment their annual risk assessment methodologies. If management is implementing ERM, internal audit should incorporate this activity into the risk assessment and audit planning process.

Internal auditor can assist the organization in the following areas,

- Giving assurance on the risk management processes
- Giving assurance that risks are correctly evaluated
- Evaluating risk management processes
- Evaluating the reporting of key risks
- Reviewing the management of key risks

(ii) However the internal auditor should not get involved in the following as it impairs his/her independence.

- Setting the risk appetite
- Authorizing and dictating the implementation of risk management processes
- Assuming the role of management in providing assurance on risks and risk management performance
- Making decisions on risk responses
- Implementing risk responses on management's behalf
- Accepting accountability for risk management

SECTION 2

Answer 03

Relevant Learning Outcome/s: 1.2.1/ 1.3.1/ 1.4.2/ 2.2.2/ 3.2.1/ 4.2.1

Suggested Detail Answer:

a)

- Sarath is proposed to be the chairman. He could have dominance over management due to the fact that it was his own business earlier.
- Sureka, being the daughter of the previous owner can have undue influence over practising of policies of the board.
- Sureka being the previous owner's daughter can have dominance over controls and functions of the company and the board.
- Balance between executive management and independent non-executive directors, is not clear, as all of them are not independent as they have ownership and family links.
- Directors representing PSP are proposed to be the son of MD of PSP and his wife. Since they are foreigners, there can be lack of involvement in the board matters.
- PSP's son who is a director, could not have relevant experience in business matters as he is a medical doctor.
- PSP's son's wife, who is a director, could not have relevant experience in business matters as she is a professional architect.
- The board does not appear to have an appropriate mix of expertise.

b)

- Area 1- Review of financial statements and systems
  - review of both the quarterly/interim (if published) and annual accounts.
  - assessment of the judgements made about the overall presentation and key accounting policies.
  - assessment of whether disclosures are in accordance with Sri Lanka accounting standards.
  - consider the Company's ability to continue as a going concern.
  - review information in press releases about results and data supplied to analysts.
  - review should cover the financial reporting and budgetary systems and controls.
  - Consider performance indicators and information systems that allow monitoring of the most significant business and financial risks.
  - consider carefully the control systems that underpin accurate financial reporting.

- Area 2- Review of internal control
  - play a significant role in reviewing internal control.
  - oversight of processes to ensure that internal control and risk management procedures are sufficient
  - review should cover legal compliance and ethics

- address the risk of fraud
- consider the recommendations of the auditors in the management letter and management's response
- active supervisory role in reviewing major transactions for reasonableness

- Area 3- Review of risk management
  - play an important part in the review of risk and in confirming that there is a formal policy in place for risk management and that the policy is backed and regularly monitored by the board.
  - review the arrangements, including training, for ensuring that managers and staff are aware of their responsibilities.
  - confirm that risk management is updated to reflect current positions and strategy.

    discuss policy and practice with respect to risk assessment and risk management.

- Area 4- Liaison with external auditors

    Oversee appointment or removal of the external auditors and the fixing of their terms of engagement and remuneration
  - review external auditor independence and conflict of interest
  - consider non-audit services provided by the external auditors and discussing scope of audit
  - have private meetings with auditors and make themselves available to the external auditors for consultation, without the presence of the company's management.
  - Discuss the audit plans, key audit issues and management response.

- Area 5 – Other duties
  - Report regularly to the board of directors
  - Assertion of confidentiality to whistle blowing employees and
  - Setting close hiring policies for employees
  - Presenting a report to the board on identified related parties and related party transactions on regular basis.

c)

- Familiarity threat due to long association by the auditor with the entity
- Investment of 500mn- valuation was required from the auditor. Self-review threat. Also valuation as required from the auditor can lead to auditing own work.

d)

- Demonstrating the commitment to place importance on control environment by the management
- Showing by practice commitment of top management to risk management
- Carrying out risk awareness and communication activities such as
- top-down communications on what the risk philosophy is and what is expected from LFPL's people.
- Training and involvement of staff in the risk management activities
- Annual performance objectives can be set to include objectives relating to risk, and risk management needs to be considered as part of the performance appraisal and reward systems
- Changing risk attitudes and not adhering to old habits.

e) i) The objective of this question is to test the ability of students to apply knowledge about various type of engagements such as assurance and related services, and structure of assignments. Therefore, any professional service proposed by the students using the following bases of engagements can be awarded marks.

- As the statutory audit has been already carried out a special assignment is required for PSP to determine the exact amount of investment.
- Also, if PSP agrees, an agreed upon procedure based "due diligence" engagement can be carried out for the year ended on 31.12.14 and three months ended on 31.03.2015 to provide findings on identified assets and liabilities and other items such as off balance sheet matters.
- A review engagement can be carried out for the period of three months ended on 31.03.2015.

ii) Areas for 31 December 2014:

- Biological assets at FV. May involve a management expert in determining the value. performance procedures that are required when management relies on its expert.
- Biological assets and AFS valuation will involve judgments and estimates, hence need to focus on them appropriately
- The value of the plants was based on an internal valuation carried out by the engineering team of PSP. How reliable is the determined value. The impact of the same on the proposed professional service outcome.
- Post balance sheet period is short. Therefore, evaluating evidence surrounding existence through subsequent settlements may not derive a conclusion. Need to focus on appropriate evidence in the absence of subsequent settlements such as evidence of sales occurrences.
- Debtors impairment will involve judgment.
- Need to determine the current status of the audit qualification regarding last year and its impact on the current financial statements
- Tax assessments are judgmental and require careful analysis of the impact on contingencies
- Related party transactions should be examined

Following areas are not so significant

- Existence of inventories due to nature of business
- Deferred tax liabilities appear too small, in comparison to the items that give rise to temporary differences
- Retirement benefits- too small
- Trade and other payables- appear to be high
- Significant variances in items
  - GP ratio change
  - Admin exp. increase
  - Distribution exp. increase
  - Finance cost as a ratio of liabilities
  - Income tax – effective rate appears to be very low

Areas for 31 March 2015: ***Following areas are significant***

- Status of tax assessments in the period up to 30 June and implications on the determined value of the business
- Northern Foods acquisition- auditing the purchase consideration, brand values acquired and any intangibles and purchase price allocation and its impact
- Status of debtors settlements

f) Students are required to apply the knowledge given in the scenario against the requirements of SLAuS 260.

- Significant estimates- Biological assets are carried based on FV measurement bases. The significant assumptions employed and the auditors feedback on such estimates and judgments should be communicated to audit committee.
- Long term investments- LKAS requires AFS to be at FV. Hence determining FV employs judgments and estimates which should be communicated to audit committee as above
- The composition of the board has a bearing on the overall control environment of LFPL. Given the lack of independent directors can have a pervasive effect on the same.
- Valuation of intangible assets – brand name.

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